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Queensland
Government

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16 June 2015

Mr Jim Murphy
Under-Treasurer
[by email]

Dear Jim

Employer Contributions to QSuper Defined Benefit Scheme

I refer to John O'Connell's email of 14 May 2015 and subsequent discussions seeking my advice on a proposed time-limited suspension of employer contributions into the investment pool held by Treasury to fund future Defined Benefit Scheme payments.

In summary, the expected surplus position of the scheme is well placed to accommodate the proposal, whilst retaining consistency with the principle of fully funding employee entitlements. The process should be given effect through a suspension of *annual investments with QIC*, rather than any suspension of employer *contributions*. I also note that the legislative guarantee provided to scheme members effectively ensures the security of their benefit entitlements.

Background and Analysis

The concept of "full funding" is not quite as well defined as might be expected. Whilst asset values are clear, the quantum of liability against which to compare the assets depends critically on the assumptions used to calculate them. This issue is discussed extensively in the publicly available valuation report and effectively comes down to two alternatives.

The "accounting" basis is that used in financial statements and effectively assumes risk-free discount rates (currently around 3%). The "funding" basis assumes that the return expectations on the assets are met, resulting in higher discount rates and therefore lower liabilities.

The distinction is important, as the liabilities are materially different on the two bases. Based on the projections used in the February 2015 Budget Update, the accounting basis was expected to show a surplus of approximately $1.2 billion at 30 June 2015, whilst the funding basis indicated a surplus of approximately $10.5 billion. However, if interest rates continue at recent higher levels the actual accounting figure is expected to end up a little higher, in the order of **$2.0-2.5 billion**.

For the preceding triennial investigations, only the funding basis was shown and so it was the measure used to decide whether liabilities were "fully funded". Both bases were shown in the 2013 valuation. In addition, comparisons with other States and the Commonwealth are done on the accounting basis, as it is the only publicly available consistent set of information. However, as a general principle, my advice in the past regarding the appropriateness or otherwise of contribution levels has been framed around the funding basis.

The proposal was framed around a *contribution* suspension but i would recommend that the process be given effect by Treasury through a time-limited suspension in *annual investments with QIC.* This would retain the existing contribution infrastructure and consistency with the contribution levels for the Accumulation scheme as well as ensuring that Departmental and other employers' budgeting processes are undisturbed. Importantly, it would also allow some flexibility to respond to any material changes in investment markets or scheme dynamics.

The projected employer contributions to the scheme over the five years to 2019-20 start around $500 million, declining in line with membership to around $400 million, with a present value at 30 June 2015 of approximately **$2.1 billion**. This suggests that such a program could be undertaken whilst still maintaining consistency with the Government's fiscal principle of fully funding employee entitlements.

It should be noted that any reduction in the surplus position will occur over time and, by definition, will reduce the capacity of the fund to withstand adverse outcomes (primarily investment returns below expectation), although the funding position is clearly very strong and will remain substantially better than all of its public sector counterparts. In any event, it is important to note that the legislative guarantee provided to scheme members effectively ensures the security of their benefit entitlements.

I note that the proposed contribution suspension is intended to apply to core Government only. Contribution rates apply equally to all employers and so differential contribution rates would be problematic to implement. However, my recommended approach resolves this issue by managing this at the investment rather than the contribution level.

Finally, I note that the current "governing" document regarding contribution levels is my formal actuarial valuation report dated 20 June 2014. Should the Government wish to pursue this proposal, it would be prudent for me to formally advise the Treasurer of the change in funding arrangements, which I would be happy to do upon request. I would also recommend that the QSuper Board of Trustees and other key stakeholders be formally advised. You may also wish to consider whether any legal advice is necessary.

I trust that this information meets your needs. Please do not hesitate to contact me if you would like to discuss further.

Yours sincerely

Wayne Cannon

Wayne Cannon
State Actuary